

# **S IS FOR SAVINGS: PRO-GROWTH BENEFITS OF EMPLOYEE-OWNED S CORPORATIONS**

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## **HEARING BEFORE THE COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES ONE HUNDRED FOURTEENTH CONGRESS SECOND SESSION**

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**HEARING HELD  
APRIL 27, 2016**

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#### Questions for the Record:

None.

#### Answers for the Record:

None.

#### Additional Material for the Record:

None.



## **S IS FOR SAVINGS: PRO-GROWTH BENEFITS OF EMPLOYEE-OWNED S CORPORATIONS**

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**WEDNESDAY, APRIL 27, 2016**

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON SMALL BUSINESS,  
*Washington, DC.*

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building, Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Luetkemeyer, Brat, Hardy, Kelly, Velázquez, Hahn, Meng, and Adams.

Chairman CHABOT. Good morning. The Committee will come to order.

Special thanks to our witnesses who have traveled to our Nation's capital and taken time away from their busy schedules to be with us here today. We are pleased to be joined today by our colleague Mr. Reichert from Washington. Mr. Kind from Wisconsin, had intended to be with us but something came up he is unable to be with us today. But they, together, introduced H.R. 2096, the Promotion and Expansion of Private Employee Ownership Act of 2015. So it is a bipartisan bill. We have provided a copy of the section by section bill for the members' information.

I am also pleased to welcome some very special guests from the Warren County, Ohio, part of my district, who are in the audience here today.

With National Small Business Week right around the corner, we must do all we can to support America's 28 million small businesses, which are responsible for 7 out of every 10 new jobs created in America today. As part of that effort, I believe that small companies in my home State of Ohio have an important story to tell about what has worked so well for them. In many ways, Ohio small businesses can serve as a model for small businesses nationwide.

I am very happy that two of our witnesses, Jay Hardy and Pete Strange, have strong ties to Ohio, and they will share their stories about one critical way we can support them and job creators like them all across America.

Our country was founded on the idea that free markets and free enterprise provide the best economic compass for a free people. At the heart of this issue is the relationship between employers, their employees, and the customers they serve. Too often, government red tape and our broken tax code interfere with this relationship, doing a disservice to all involved.

Our economy works best when America's entrepreneurs are free to make their own decisions, take their own risks, and run their

businesses as they see fit—free from government interference. That is exactly what employee stock ownership programs, or ESOPs, do.

If companies so choose, they can convert employees into owners who share in the profits of the company. This equity lets them share in the American Dream and have a stake in their own future. It also helps them save money as they plan for their golden years.

S corporations have only been allowed to form ESOPs since 1998. Since then, the research has reinforced what we hear from small businesses all the time—this structure works, and it works especially well for small companies. H.R. 2096 would provide additional help for S corporations interested in forming ESOPs, strengthening these important vehicles—that being the ESOPs—as vehicles that more and more companies would be able to take advantage of to help their employees.

I am looking forward to hearing from our very distinguished panel of witnesses here this morning, and at this time, I would like to yield to the Ranking Member, Ms. Velázquez, for her opening statement.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. Good morning.

As part of their retirement plan, Americans have traditionally relied on employer-based options. For small firms, however, providing such plans is a two-prong challenge. They not only have to set up and administer the plan, but enroll their employees as well. This resource and time-intensive process has resulted in only 14 percent of small firms offering such a benefit. A recent approach to helping more small companies provide for their employees are through employee stock ownership plans (ESOPs), a type of defined contribution retirement plan. Companies using this plan not only provide a retirement savings vehicle, but also provide more stable employment than other businesses. Reports have shown that they even outperformed the S&P 500 Total Returns Index in terms of total return by participant by 62 percent and distribution to participants totaled nearly \$30 billion in a decade. These numbers are impressive and merit a closer look at ESOPs. We must also investigate why more small businesses are not using this beneficial plan. Today's hearing will give us that opportunity.

While the S ESOP has only existed for a short while, we are seeing the benefit to employers, employees, and the national economy. In fact, the number of ESOPs have more than doubled since 2002, proving they are worth the trouble and expense for a business to use.

Nevertheless, the ESOP is still a very foreign concept for many small business owners. Whether it is due to a lack of awareness or intimidation from the complex rules, I hope to find out today where the primary challenges lie for small firms. But whatever the reason is, we should be doing more to enlighten employers and make it a more attractive retirement vehicle. As our population ages, it is critical that small employers and their employees have access to quality financial security in their retirement years. We have made strides to enroll more workers through the my RA payroll deduction account and state-sponsored retirement savings plans, like automatic IRAs and multiple employer plans. We can do better and S ESOPs are one option.

I look forward to hearing from our witnesses about the advantages of S ESOPs and what challenges face owners who decide they are the right move for their business. Today's discussion about H.R. 2096 will also help educate members on the bill and how it is meant to attract small business employers to this plan.

In advance of the testimony, I want to thank all the witnesses for both your participation and insights into this important topic. With that, Mr. Chairman, I yield back.

Chairman CHABOT. Thank you very much. The gentlelady yields back.

If committee members have opening statements prepared, I would ask that they submit them for the record.

I will now take just a couple moments to explain our timing system that we have here. It is a 5-minute rule that we operate by. It is pretty simple. You will have a lighting system to help you out. The green light stays on for 4 minutes and then a yellow light will come on and let you know you have about a minute to wrap up. When the red light comes on, we would ask you to try to stay within that if possible. If you go over a little bit we will give you a little flexibility but not a lot. So we would ask you to try to do that, and we hold ourselves to the same 5-minute rule. We are stricter there than we are with you all.

We will begin by introducing our witnesses. Our first witness is Pete Strange, who is chairman emeritus of Messer, Incorporated, which is based in my hometown of Cincinnati, Ohio. Messer, Inc. is the parent company of Messer Construction Company, a regional general contractor and construction manager, and Messer Financial Services, a diversified investment firm. Mr. Strange served as Messer's chairman from 1990 through 2013, so for 23 years. He has also served on a variety of community and industry boards in Cincinnati, including the Cincinnati branch of the Federal Reserve Bank of Cleveland and the Cincinnati USA Regional Chamber of Commerce, among others.

Our second witness is Jay Hardy, president of Hardy Diagnostics in Santa Maria, California, and also in our district. This morning, Mr. Hardy will be testifying on behalf of the Warren County Chamber Alliance of Warren County, Ohio. Party Diagnostic manufactures over 3,500 different products used in microbiology laboratories. Currently, they have two manufacturing facilities, one in Santa Maria, California, and the other located in Springboro, Warren County, Ohio, which as I mentioned before, is in our district.

Our third witness today is Alex Brill, who is a resident fellow at the American Enterprise Institute in Washington, D.C., here. Mr. Brill is also the CEO of Matrix Global Advisors, a Washington, D.C.-based economic policy consulting firm. Prior to this, Mr. Brill was the policy director and chief economist of the House Ways and Means Committee. He also served as an advisor to the Simpson-Bowles bipartisan Deficit Reduction Commission, and as staff economist to the White House Council of Economic Advisors.

We welcome all three of you here, and I would now like to yield to the ranking member for the purpose of introducing our fourth witness.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. It is my pleasure to introduce Ms. Stephanie Silverman, president and executive di-

rector of the Employee-Owned S Corporations of America. She is also founder and CEO of Venn Strategies LLC. Before launching her own firm, Stephanie was a senior advisor in the Washington, D.C., government relations practice of Manatt, Phelps and Phillips, a national firm specializing in matters of national and international policy. She holds an MBA from the Wharton School of Business and an undergraduate degree from Duke University. Welcome.

Chairman CHABOT. Thank you.

Now having introduced our panel, we will hear from them. We will begin with Mr. Strange. You are recognized for 5 minutes.

**STATEMENTS OF PETER S. STRANGE, CHAIRMAN EMERITUS,  
MESSER, INC.; JAY HARDY, PRESIDENT, HARDY  
DIAGNOSTICS; ALEX BRILL, RESIDENT FELLOW, AMERICAN  
ENTERPRISE INSTITUTE; STEPHANIE E. SILVERMAN, PRESI-  
DENT AND EXECUTIVE DIRECTOR, EMPLOYEE-OWNED S  
CORPORATIONS OF AMERICA**

**STATEMENT OF PETER S. STRANGE**

Mr. STRANGE. Chairman Chabot, Ranking Member Velázquez, and distinguished members of the Committee, thank you for inviting me to testify before you today to share my story of inclusive capitalism and the impact it has had upon hundreds of my fellow employees at Messer Construction. Thank you for holding this hearing to learn more about ESOPs and legislation that can encourage more businesses to become employee owned.

My name is Pete Strange and I began working at Messer Construction as a project engineer in 1968. I retired from management a couple of years ago after 23 years as CEO. Mine is the tale of two careers. In 1968, Messer was a Cincinnati-based, medium-size, family-owned construction company with a long history and a good reputation. Like most companies in construction, it had little in the way of employee benefits. By 1990, company-funded retirement benefits totaled only a million and a half dollars on behalf of 99 participants. In 1998, the last son of the company founder died and we found ourselves with an uncertain future. The grandchildren of the founder wanted access to their wealth, and having no connection with the employees, were not committed to maintaining employment at the company.

In 1990, the Messer employees were able to buy their future from the Messer family using the ESOP structure. I led the employee group through those negotiations, so I can tell you firsthand that we employees could not have purchased the company if not for the important tax advantages that the ESOP model afforded us. Our company's investment in ESOPs allowed 99 Messer employees to purchase our future, and the engagement that opportunity created has resulted in growth. Today, operating from nine regional offices, Messer performs more than a billion dollars in construction annually, focusing upon health care, higher education, and life sciences projects.

Here is the measure of the change that our ESOP brought to our retirement savings. Messer now provides quality jobs and predictable retirement for over 1,000 individuals and has company-funded

retirement assets for those employees, totaling more than \$220 million.

Through our engagement with the Employee-Owned S Corporations of America, we have come to know hundreds of companies with stories similar to ours, and the data from ESCA's quality research shows that ESOP companies are more robust, more sustainable, and provide higher levels of diversified retirement benefits than non-ESOP companies.

The Messer ESOP is in place and it is working well for us. However, Messer manages a vendor supply chain of small local subcontractors who are increasingly at risk from forces both external and internal. Creating a more supportive environment for those companies to form ESOPs, both for the benefit of their employees and to reduce the risk and volatility that results from unplanned succession will be a direct benefit to our communities, to our customers, and to our company as we compete in a global economy.

I have had only one employer in my more than 40-year career, but I have had two completely different employment opportunities. Messer is a clear example of the power of inclusive capitalism that results from supporting sub-S ESOPs. I invite you to visit us or an employee-owned company in your district or State so you can feel firsthand the pride employee-owners take in their work and the confidence that employee-owners have in their future.

Mr. Chairman and committee members, I thank you for this opportunity to address the Committee and share Messer's story, and for your consideration of legislation that will allow more hard-working Americans to share in the American Dream at work. Thank you.

Chairman CHABOT. Thank you very much. We appreciate it.

Mr. Hardy, you are recognized for 5 minutes.

#### **STATEMENT OF JAY HARDY**

Mr. HARDY. First of all, I would like to thank Chairman Chabot today for inviting me to voice my support of H.R. 2096 and the proposed incentives to increase employee ownership in America. I would also like to thank Ranking Member Velázquez and the other members of the Small Business Committee.

My name is Jay Hardy. I am the president and founding partner of Hardy Diagnostics, a medical device manufacturer based in California with a manufacturing facility in Ohio and Texas. We have been in business for 36 years servicing the laboratory industry, and we currently have 350 employees.

Four years ago, I sold 70 percent of my shares to our newly formed ESOP. Last year, I sold the remaining shares, making our company a 100 percent employee-owned S corporation. I have never had any regrets in making this decision, which has set our company on a course of increased growth and prosperity for the reasons that I would like to describe for you today.

Since becoming an ESOP, our company has grown by 78 percent, so I think the numbers speak for themselves. The ESOP structure was defined in Congress as a part of the ERISA laws in 1974. Just as Abraham Lincoln's Homestead Act of 1862 created wealth for ordinary citizens by granting them 160 acres of land, the ESOP also has the potential to create wealth for all Americans without having

to own land. Within the ESOP, employees are granted shares of the company they work for without cost to them or taxation.

Currently, there are over 11 million ESOP participants in America. This number needs to grow, and here is why. Recent studies have shown that ESOP companies are 25 percent more likely to stay in business than non-ESOPs. Employee-owners were four times less likely to get laid off during our last recession. Employee-owners have two and a half times more money in their retirement accounts than non-ESOP employees. Employer-owners receive 5 to 12 percent more in wages than non-ESOP employees. Employer-owners are 5 to 10 percent more productive than their non-ESOP counterparts. So you can see that ESOPs are undoubtedly a very good thing for the American worker, and thus, very good for the American economy in general.

Today, we hear a lot of talk about income inequality and capitalism being good only for the privileged 1 percent. Why can capitalism not be accessible for all American workers by owning a portion of the companies that they work for? While capitalism may have its flaws, the modern ESOP provides a way to correct those flaws. This is why the ESOP has been nicknamed “universal capitalism” or “capitalism for the masses.” The employee-owners turn out to be highly motivated because they know that their efforts will be directly rewarded through an increase in share value. This, in turn, makes the American ESOP more able to successfully compete in the world market.

Today, many workers are afraid that Social Security or their meager 401(k) savings will not be adequate for their retirement. The ESOP will substantially supplement those retirement programs in a very significant way.

The original idea of employee ownership came from Lewis Kelso, who formed the first ESOP in 1956. He said, “The trouble with today’s finance is that they are designed to make the rich richer. None is designed to make the poor richer.” He also said, “If capital ownership is good for the rich, it is a thousand times better for the middle-class and the poor.”

The workers at Hardy Diagnostics now know that their daily work is not drudgery but rather an exciting investment in their own personal financial future.

In preparation for this testimony today, I asked the employee-owners of our company to provide me with their own thoughts about the ESOP which they own. One of them said, “Since becoming an ESOP, I have found an avenue in which every employee has an opportunity to be engaged in our company’s steady climb of growth. As a manager, nothing is more rewarding than seeing individuals in my department with such a high level of enthusiasm for the success of our company, as well as their own personal growth and achievements.” Another employee-owner said, “Being a part of an ESOP breaks down title barriers. We all have the same title, owner. Ownership inspires greater value and satisfaction in our daily work. Our work turns into an investment. It is no longer just a job.”

So I think you get the idea. H.R. 2096 is an excellent piece of legislation that provides the necessary incentives for S corp business owners to create an employee-ownership program. This will

make the S corp ESOP a very attractive exit plan for business owners that wish to do the right thing in turning the ownership of their companies over to workers who made the business successful. H.R. 2096 also provides incentives for banks to fund the loans that make this transaction possible.

Capitalism, for all its flaws, remains the best economic system the world has ever known. Let's improve upon it by putting true ownership within reach of all American workers through the wealth-building program of the modern ESOP. I am passionate about employee ownership, and I enjoy being an evangelist for the ESOP movement here in America.

I thank you once again, and I would be glad to answer any questions you may have.

Chairman CHABOT. Thank you very much.

Mr. Brill, you are recognized for 5 minutes.

#### **STATEMENT OF ALEX BRILL**

Mr. BRILL. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, thank you for the opportunity to appear before the Committee to discuss the role of S ESOPs in the U.S. economy. Allow me to summarize my written testimony which has been submitted for the record.

S ESOPs define contribution retirement plans that allow employees to become owners in their employer exist across a wide spectrum of industries and include a meaningful number of U.S. employees. S ESOPs can improve worker commitment, increase firm productivity, reduce worker turnover, and lower production costs. S ESOPs proved resilient in the face of the most recent recession, and thereby, helped mitigate the adverse effects of the recession on S ESOP suppliers and related business activities.

A few specific facts. The number of S ESOPs has increased 131 percent from 2002 through 2013, reaching 2,626 by my count. This increase has been steady year over year aside from a slight dip during the recessionary period in 2008. More important, however, than the trend in the number of S ESOPs is the increase in the number of employee-owners working at these firms. The number of active participants at S ESOPs increased 167 percent from almost 200,000 people in the year 2002, to over 520,000 in the year 2013. Since 2008 alone, active participants at S ESOPs have increased 30 percent.

It should be noted that because not all employees are necessarily S ESOP owners, the number of participants, the statistics I was just citing, is a conservative estimate of employment by these firms.

Some of the growth in S ESOP employment is attributable to firms hiring more workers, and some is attributable to the rising popularity to S ESOPs generally. In other words, this large increase in S ESOP employment I just described does not entirely represent just organic job growth within S ESOPs; it also reflects firms converting to S ESOP status. I analyzed the subset of all the S ESOPs, those operating consistently from the period 2002 through 2014, and found that in these firms, employment grew 30 percent, while at the same period, overall U.S. employment grew just 6 percent.

Now, a word about the economic evidence. ESOPs tend to perform better than their peers, and the mechanism by which this occurs is at least, in part, the additional commitment workers make as they become owners in their firms. This is particularly important in the small business context. The success of small- and medium-sized enterprises is often reliant on the ability of firms to ensure their employees work effectively and cohesively.

Higher worker commitment and lower turnover rates are key components for small business success in an increasingly competitive marketplace. By strengthening this worker commitment to their employer, the S ESOP structure can help foster efficiency, increase productivity, and grow output.

I would also like to stress that the benefits of S ESOPs are not limited to just their firms and their employees. The demonstrated resilience of S ESOPs benefit the whole economy. For example, during a recession, bankruptcy for small businesses is not uncommon, and this can have a domino effect, imposing financial hardships not only on workers, but on the firm's suppliers and other local businesses. To the extent that S ESOPs mitigate these effects through their resilience, they represent and offer a positive externality to the economy.

In conclusion, as the U.S. seeks to rebound from a period of tepid productivity growth, S ESOPs are a valuable tool in promoting growth, not only among small businesses, but indirectly in the economy overall.

Thank you, and I would be happy to answer your questions.

Chairman CHABOT. Thank you very much.

Ms. Silverman, you are recognized for 5 minutes.

#### **STATEMENT OF STEPHANIE E. SILVERMAN**

Ms. SILVERMAN. Good morning, Chairman Chabot, Ranking Member Velázquez, and distinguished members of the Committee. My name is Stephanie Silverman, and I am president and executive director of the Employee-Owned S Corporations of America. Thank you for the opportunity to testify today about the success of S corporations that are owned by their employees, or S corporation ESOPs, and on bipartisan legislation to expand employee ownership.

ESCA represents S ESOP companies in every State, in industries from heavy manufacturing to construction to school photography. Since first being allowed to form in 1998, the nearly 3,000 S ESOP companies in the U.S. now account for \$92 billion in direct output to the U.S. economy each year. Twenty years ago, Congress passed legislation creating S ESOPs. Congress's goal was to encourage employee ownership of private industry, enable workers to benefit from their labor, and create a path for building meaningful retirement savings. Data shows that today S ESOPs are doing precisely that. Twenty years later, private S ESOP companies have been a remarkable success story, a bright spot in an economy characterized by sluggish growth, anemic job creation, and worker insecurity. Many studies by renowned economists from across the ideological spectrum illustrate how S ESOPs are powerful for workers as a retirement savings and economic security tool and how they have

contributed to communities and to the national economy. I will touch on a few key points from the most recent studies.

Earlier this year, economist Jared Bernstein released a study that shows S ESOPs reduce wage and wealth inequality. Bernstein also found ESOP companies pay their workers better wages and provide them with more stable employment than other comparable businesses. With Congress searching for solutions for boosting worker savings, job prospects, and wages, the S ESOP's success story reminds us this goal can be reached through capital ownership shared among workers.

At a time when almost half of working Americans do not have any retirement plan at work, S ESOPs also provide unparalleled worker retirement savings opportunities. As Ranking Member Velázquez recently noted, between 2002 and 2012, S ESOPs outperformed the S&P 500 and their net assets increased over 300 percent, allowing them to distribute nearly \$30 billion in retirement savings to their employee-owner participants.

The savings benefit to employees does not come with additional risk. Moreover, private employee-owned businesses are proven to be more stable than their counterparts. In 2014, the National Center for Employee Ownership released data showing that the default rate on bank loans to private ESOP companies was an astonishingly low 0.2 percent annually. This compares to mid-market companies defaulting on loans at a rate 10 times higher or greater.

Eight years ago, as members of Congress began to hear from companies and workers in their districts, they began asking, what can Congress do to encourage more S ESOPs to form? The answer to that question prompted what is currently H.R. 2096, the Promotion and Expansion of Private Employee Ownership Act. First introduced by Congressman Ron Kind in the 111th Congress, the bill has been introduced in the subsequent three congresses led by Congressman Dave Reichert and Mr. Kind. Today it has 67 bipartisan cosponsors, including 21 members of the Tax Writing Ways and Means Committee, and in the Senate, the counterpart S. 1212 has 28 cosponsors. In short, that bill would provide incentives to owners of S corporations to sell their stock to an ESOP. Today those incentives exist but only for owners of C corporations. Section 1042 of the Tax Code allows a C corporation owner to defer the recognition of gains when the owner sells shares to an ESOP. Expending parity to S corporation owners is the single-most significant legislative action that Congress can take to encourage more of the millions of S corporation owners to choose an ESOP when they consider how to transition their businesses from their current ownership structure. It also would encourage banks to lend to S ESOPs to create more ESOP ownership of companies. Under the proposal, banks could deduct 50 percent of interest income on certain loans made to an ESOP. Employees often lack the funds to buy a company directly, and not all banks understand the ESOP structure, which may cause them to limit lending to these vibrant businesses. This incentive can address those challenges. It would provide assistance to would-be S ESOP companies through an employee-ownership assistance office at Treasury, and it would permit an SBA-certified small business to remain eligible for SBA programs after becoming majority-owned by an ESOP.

Quite simply, more S ESOPs mean more worker savings, more wealth and wage equality, and more job stability. That is why we hope this committee, and your colleagues in Congress, will help advance this vital measure. Thank you for the opportunity to testify, and I would be happy to answer any questions.

Chairman CHABOT. Thank you very much.

We will now go to the questioning part, and I will begin with myself. I will begin with you, Mr. Strange, if I can. Where do you expect that your company would be now had it not converted to an ESOP back in 1990? I know it is impossible to know that, but if you could try.

Mr. STRANGE. The opportunities that the family considered, in addition to selling to the employees, were to sell the assets, we had some equipment and property, or to sell to a larger construction company. What is certain is that the company would not exist and would probably not be housed in Cincinnati, Ohio, if the employees had not purchased it. What is equally certain is that the math worked in our favor. Because of the rollover, the sellers were able to get a better deal from us, and because of the long-term thinking of the ESOP, we describe Messer as a "get rich slow" scheme, we were able to amortize our efforts in buying the capital over a much longer period of time than a normal financial buyer would have.

Chairman CHABOT. Thank you. How many employees were impacted at that time then as a result of this?

Mr. STRANGE. Ninety-nine.

Chairman CHABOT. Ninety-nine.

Mr. STRANGE. There were 99 employees in a recently formed—it is 4 years old—profit-sharing plan that had the 1.5 in it. Prior to that we had no retirement plan because the hearty independent folk in construction thought we ought to fend for ourselves.

Chairman CHABOT. Okay. One thing that I can testify to is when you drive around the greater Cincinnati area, you will see an awful lot of construction going on with the Messer name on there, so they do a lot of work all over other place.

Mr. STRANGE. Thank you.

Chairman CHABOT. Thank you.

Mr. HARDY, I will go to you next, if I can. What changes did you notice in your company, and employees, especially, after it became employee-owned?

Mr. HARDY. There were a lot of changes. I think one, would be that people had more enthusiasm for their jobs. In the past it was kind of a problem. People punch in, they punch out. Some of them were not fully engaged in what we are doing, but I have seen a remarkable change over the last 4 years. They were getting very, very interested, and we are teaching them business practices. All of our employees learn a little bit about how to interpret financial statements. They look at income statements and balance sheets. We are also an opening book management company, so all the books are open to all of our employees. They can see how we are doing month-to-month, and they appreciate that. Whether it is good news or bad news, they see all that. I think there is more of a spirit of cooperation. Productivity is up. Sales are up. It has just been a terrific change for our company.

Chairman CHABOT. Thank you.

Mr. Brill, as you have studied employee-owned companies over the years, what are the most compelling factors you found that contribute to their success? Also, what would you say are the biggest barriers that you have identified to the creation of more ESOP companies?

Mr. BRILL. Thank you, Mr. Chairman.

The evidence, both the survey evidence and some of the empirical research, really mirrors the testimony that Mr. Hardy just offered, that workers are more enthusiastic. The terminology I used in my testimony is worker commitment, but these are basically the same notions, that workers feel better about going to work. They are more willing to work hard, to put in a little extra, to stay a little late. They are more aware of their surroundings, more willing to offer suggestions to their managers about how things could be done better and more efficiently. There is evidence that employees in ESOP structures, S ESOPs included, require less management, and that is a cost savings. If you need fewer managers to keep an eye on the workers, you are saving money, knowing that the employees are motivated themselves for hard work.

Chairman CHABOT. Thank you. Are there any barriers that you have seen?

Mr. BRILL. It does seem surprising that there are not more S ESOPs, to be frank, and I am not quite sure why that is. There seems to be some sort of breakdown in the communication in the marketplace about owners and founders not being aware of these tools.

Chairman CHABOT. Perhaps because of the huge following that we have in this Committee over the C-SPAN coverage that we get, that there will be far more soon.

Mr. BRILL. Hopefully.

Chairman CHABOT. Thank you.

I am almost out of time, but let me turn to you, Ms. Silverman. How safe are ESOPs when employees have their retirement savings tied up to the success of the business? Would you comment on that?

Ms. SILVERMAN. Thank you, Mr. Chairman. The question speaks to the issue of diversification, and I think that it is important to understand that S ESOPs provide some of the most diversified retirement opportunities. First, because ERISA requires the ESOP structure to allow for diversification. As an employee gets further along in their tenure and older, ERISA requires a company to allow employees to begin diversifying out of the ESOP plan. Second, while most U.S. companies, about half of U.S. companies, do not offer any retirement savings at work, the ESOP is a plan in every ESOP company. About 85 percent of ESCA's members offer at least one additional plan at work. Usually that is a 401(k) plan, but it can be a profit-sharing plan as well. I think you will find that the culture of employee ownership encourages companies to take better care of their workers.

Chairman CHABOT. Thank you very much. My time has expired. I will now yield to the ranking member for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Brill, and maybe Ms. Silverman, I am interested to know if any of you have analyzed how many minority small business own-

ers have adopted ESOPs? How can we encourage more minority small businesses to adopt ESOPs?

Ms. SILVERMAN. There has not been a full analysis of the question, but I can tell you from anecdotal evidence that there are too few minority business owners that have adopted this structure. I would attribute that from my own experience to a few factors.

Number one, there is a certain level of education that company owners need to have. Only more sophisticated companies currently have access to the informational resources that they need to form these structures.

Number two, as you yourself have noted in the past, there are capital access challenges for minority-owned businesses that are, unfortunately, disproportionate to the broader universe of small companies. We believe that encouraging banks to provide more capital access for purposes of transitioning to an ESOP will help to overcome that.

Ms. VELAZQUEZ. Mr. Brill, do you have any comments?

Mr. BRILL. No, I do not.

Ms. VELAZQUEZ. Mr. Strange, you helped lead the 99 employees in their buyout of Messer. What is the process for establishing an ESOP, and how expensive and time-consuming was this process?

Mr. STRANGE. The challenge was coming to common ground with the sellers. In our case, the sellers were not motivated by the welfare of the employees or even the continuity or sustainability of the enterprise. We spent considerable time in negotiating what was defined as a fair price. I do believe the perception of expense in creating an ESOP is a significant barrier for smaller companies. In our case, we used almost all local consultants. We had one national valuation firm that worked with us, and we found it to not be unbearably expensive, which was really important, because we did not have access to capital. That was very important for us.

Ms. VELAZQUEZ. Thank you.

Ms. Silverman, a major drawback that I see in using an ESOP is it can jeopardize a small business' eligibility to participate in both the SBA and VA programs. The treatment of ESOP stock as either outstanding or excluded is critical to this determination. In fact, it became a problem for one service-disabled, veteran-owned small business who lost the designation because of their ESOP. Can you please explain this issue generally and how the legislation, H.R. 2096, addresses it?

Ms. SILVERMAN. I think you raise a very important question, Congressman Velázquez, and let me say this. There are very important concerns that remain to be rectified in the area of preserving minority- and women-owned and veteran-owned status. There are ways to structure additional provisions which we are currently looking at. We would be open to working with your office on, that would enable an ESOP company, if it had that designation prior to forming an ESOP, to retain that designation. Not to have special privileges, but simply not to lose its privileges. There are ways of rectifying that.

Ms. VELAZQUEZ. So do you agree with me that section 6 of the bill is not enough?

Ms. SILVERMAN. I agree with you that we would love to work with you on an expansion that includes more companies. Yes.

Ms. VELAZQUEZ. Okay.

I will ask any one of the panelists to comment or react to this question. We have heard the benefits is a tool for retiring business owners, but what about employees? What advantages does an ESOP have for them?

Yes, Mr. Strange?

Mr. STRANGE. The average turnover in commercial construction across the country is 28 percent per year. The ESOP, because of the longer term thinking, the deeper engagement, ours is a very, very small percentage of that. That level of stability allows employees to have better control of their future. The ESOP process requires communication with the employees, both to be successful and by rule. Having the information to make informed decisions about an individual's own future and their family's future is a huge differentiator. Finally, the requirement that you have an independent valuation each year gives a level of discipline to strategic planning that we never had before.

Chairman CHABOT. The gentlelady's time is expired.

Ms. VELAZQUEZ. Thank you.

Chairman CHABOT. The gentleman from Mississippi, Mr. Kelly, is recognized for 5 minutes.

Mr. KELLY. Thank you, Mr. Chairman. I thank the witnesses for being here. This is for the full panel. What is the ideal type of company that can benefit from transitioning to employee ownership? Is it a better fit for any special type of company, like construction, manufacturing, et cetera, versus other types? Are there any type of companies that should not become ESOPs?

Ms. SILVERMAN. I think it is important to understand that an ESOP can make a good company great, but it cannot make a bad company good. I can say that from our experience, we do not believe that the ESOP structure is a good idea for companies that are in jeopardy or look at it as a way to salvage a business that is otherwise at risk, for reasons outside of the ESOP structure. Companies that tend to be more capital-intensive benefit more from the ESOP structure, but we have seen ESOPs be very successful and service businesses as much as in manufacturing and other kinds of companies. It is important to keep in mind that because, as Mr. Hardy has suggested, they offer such a thoughtful way to transition ownership from an existing owner or founder. A company that is founded by an individual or group of individuals where there is no obvious successor available makes a very good candidate for an ESOP substructure, especially when the alternatives are private equity or a large foreign acquirer.

Mr. KELLY. Mr. Brill, did you have any comments?

Mr. BRILL. Thank you. I would echo Ms. Silverman's comments. We observe in the data S ESOPs operating across a wide spectrum of industries today, both capital-intensive as well as service. The seven largest, for your information, industries that are home to S ESOPs are health care, manufacturing, retail trade, financing insurance, professional services, construction, and wholesale trade. Together, these seven industries represent approximately 70 per-

cent of all the active participants in S ESOPs. You see how diverse of a set that is.

Mr. KELLY. This is for you, Mr. Brill, you might not know the answer to this. You talked a little bit about during the recession the formation of S ESOPs was not quite as much, but how did they weather the recession as opposed to other similar-type businesses? Did they do better or worse, or do you know?

Mr. BRILL. We do have information on that question, both from research that I have done as well as other economists who have looked at that very issue. In general, S ESOPs outperformed similar companies during that period, 2007, 2008, 2009. We saw overall in the economy not only a significant decline in overall employment, but also a very small rebound in employment, as everyone on this Committee is well aware with total employment not reaching its previous stationary levels until sometime in 2014. Within the S ESOP community, there was a drop-off, as there was across the whole economy, but a rather sharp rebound. By 2009, I believe, the number of active participants in S ESOPs had exceeded its previous high. That is the resilience to which I was suggesting earlier.

That is not only good for the workers who did not lose their jobs because their firms are more committed to them as they are more committed to their firms, but it is also good for the non-ESOPs in their community, whether it be the sandwich shop across the street or the supplier to those companies.

Mr. KELLY. It is really not surprising to me that when you allow people to be vested in something, and to have to work and to earn it, that they appreciate it, and the benefits are coming to them if they work harder, so I thank you all.

Very briefly, Ms. Silverman, what do you think are some of the biggest misconceptions that Congress has about the ESOP companies?

Ms. SILVERMAN. I think that the single biggest misconception is that it is a lack of diversification; that employees are at risk somehow because they have retirement savings tied up in the fate of their company. The truth is that diversification is a very real phenomenon, more so in an S ESOP company than virtually any other comparable company in the economy that we know of. They generate a lot more retirement savings individually, and they have much more diversified plans and a much more, thoughtful compliance structure to ensure that employees are taken care of.

Mr. KELLY. Thank you, Mr. Chairman, and witnesses. I yield back.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentlelady from California, Ms. Hahn, is recognized for 5 minutes.

Ms. HAHN. Thank you, Chairman Chabot, and Ranking Member Velázquez, for holding this hearing, and thank you to the witnesses for being here and testifying before us. Mr. Hardy, you mentioned it first, and it is true, every time you turn on the TV or particularly during this political season, we always hear someone talking about income inequality. It is clear that the American people are concerned about that and those wishing to lead our country in the future are concerned about that. While we are constantly hearing, I think both sides of the aisle have been talking about how to ad-

dress these concerns. It has been really amazing to hear from our witnesses today that prove you do not have to choose between people and profits. You can follow business practices that actually promote both.

Mr. HARDY. I really want to commend you for taking the risk and making your company a 100 percent employee-owned corporation. It is clear that your risk paid off. Your growth has been pretty phenomenal.

What inspired you to make this change? We have heard about the education that needs to take place to make this transition. What inspired you, and who answered all your questions that you must have had going through this? Is there someone in our Small Business Administration that has been helpful?

Mr. HARDY. Very good question. Well, for myself, personally, I wanted to make sure that our company would outlive me. I wanted to see that the company would go on and not be purchased by an outside company because I wanted to protect the jobs that we worked so hard to gain.

As far as outside advice, we have a company that we work with. It is a third-party administrator that gave us good legal and accounting advice. Going back to what Congressman Kelly said, we were told at the time that if you have under 25 employees it could be very costly and very difficult. We had over 100 at the time. We spent approximately, I think it was \$25,000 to \$30,000 in setting up our ESOP with our legal and accounting fees, which was less than I thought it would cost. There are some ongoing fees in administering the program, but it is definitely within reach. There are a lot of people and a lot of organizations that give help to companies like ours. The National Centers for Employee Ownership, NCEO, is one of them. The ESOP Association is another one of them. They have conventions that they had. They are very supportive. They are promoting education amongst business owners.

Ms. HAHN. What would be your greatest piece of advice that you would give other businesses who are considering making this transition?

Mr. HARDY. Like I said in my testimony, I think it is the right thing to do. It is good for the employees. My employees, they are the ones that created the profit, and it is only fair to them that they get to enjoy the profit that they worked so hard for.

Ms. HAHN. Thank you.

Mr. HARDY. So they own it, and they are happy to do that.

Ms. HAHN. Thank you.

Ms. SILVERMAN, I was going to follow up on this whole education piece because you mentioned to a response to our ranking member's question about women-owned, minority-owned companies, and you put the onus on maybe lack of education. How can we improve that? How can we improve that kind of outreach? What is the right vehicle to actually administer this kind of education and outreach so that businesses could think about having more of an opportunity to transition to employee-owned?

Ms. SILVERMAN. Thank you for the question. We believe that the right central hub for information is probably the Treasury Department because this is a law that combines tax policy and a defined benefits policy—or a defined contribution policy. The com-

bination of ERISA and taxes is a funky place to go for anybody to go to other than the Treasury Department. As Congress makes clear that it is more supportive and encouraging, I think it sends a message to the market. There was for a time a chilling effect. There was a worry that Congress would tinker with this in unintended ways and harm the structure. The more that Congress provides support through rhetoric, through advancing policy that encourages this, I think small business owners will get the message.

Chairman CHABOT. Thank you. The gentlelady's time is expired.

The gentleman from Nevada, Mr. Hardy, who is the chairman of the Subcommittee on Investigations, Oversight, and Regulations, is recognized for 5 minutes.

Mr. HARDY of Nevada. Thank you, Mr. Chairman.

Myself, my partner and I started an S corp some 2 decades ago, and had the privilege of employing quite a few people at our peak. At the time, when we started trying to distribute shares out to our company, portions of the company did not know about the ESOP program until the economy became a little different.

My question is, the reason we started bringing employees into our company, during the 2000 era, we were going very fast, and large corporations from overseas were looking at buying many companies up in Nevada, particularly construction companies, and we did not want to sell. We had an opportunity to sell our company out, but because we cared about our employees and enjoyed the type of craft that we were doing, we decided to work to where our employees could buy us up in a different direction. Then things changed, so once we heard about the ESOP it was too late. Do you believe this is an opportunity for these ESOP companies to help protect against big overseas companies coming in and diluting, and taking employees, and changing the environment, which it has in the Las Vegas valley? Do you see that as a protection for jobs here at home?

Mr. STRANGE. Absolutely. My answer to why do an ESOP is because it is a competitive advantage. The return we get on the professional development and training is longer and more profound, more engaged. Training that is part of an ownership culture is more engaging. If you look at the challenge that we have as project leaders in construction, there are about 7.5 million employees in commercial construction in this country. There are more than 500,000 employers. That is an invitation to someone having a financially-driven consolidation plan, and ESOPs are protection that creates a people-focused plan for those companies. We think that we need to do more.

To the ranking member's question about minority firms, once it becomes not just a matter of how you are going to make a living but how you are going to live your life, it changes how you invest in those areas as well. It is a competitive advantage and it is important protection.

Mr. HARDY of Nevada. This is to anybody on the panel who wants to answer it. How did you find out about the ESOP program?

Mr. HARDY. I found out about it through attending some of the conventions and seminars that I mentioned. These are going on all

the time. It just appealed to me. It is very worker-friendly. As Mr. Strange said, it is the best thing for them and their families. There is a lot of information out there for people that want to seek it out.

Mr. STRANGE. I knew less than nothing so I went to the library. All I learned in engineering school was two things. One was not to panic in the face of complexity, and the other was to respect data. So I just went down to the business desk and said, "What does ownership look like?" They gave me some articles.

Mr. HARDY of Nevada. Thank you. One of the questions I have had as an owner myself in the past is the C ESOP, how does it work with all different levels of the employee class? Can somebody answer? Recently there was a casino in my hometown that just got purchased by an ESOP. How does that work with the different levels of employees?

Ms. SILVERMAN. I can try to answer that. Thank you for the question.

ERISA requires that you treat all employees equally. There are guardrails to ensure that highly compensated individuals cannot take more, or do better. So the casino worker in the mailroom is treated proportional to the CEO of the company. It is also true that people receive distributions. They all have to get distributions once they qualify. You cannot distinguish between different shares of ownership. Another thing about an S corporation, which you may recall, Congressman Hardy, is that you cannot have different classes of stock. Everybody has to be the same kind of a shareholder. There are also limitations on how high compensation can be treated for purposes of proportionality. I think it is about 200 thousand dollars. It does not matter. They do not treat you as if you had any more money. It is intended to be a level playing field for everyone.

Mr. HARDY of Nevada. Thank you. I can see my time has expired.

Chairman CHABOT. The gentleman yields back.

The gentlelady from North Carolina, Ms. Adams, who is the Ranking Member of the Investigations, Oversight, and Investigations Subcommittee, is recognized for 5 minutes.

Ms. ADAMS. Thank you, Mr. Chairman, and Ranking Member Velázquez. Thank you for holding this hearing, and thank you for your testimony.

Ms. Silverman, SBA-guaranteed ESOP loans exist to help retiring business owners, how common are these loans and what can the proceeds be used for? Someone talked about the risks, and I am curious about how well educated the employees are. I know you can get information on your own, but what kind of education do you do maybe as a company?

Ms. SILVERMAN. Thank you, Congresswoman Adams. I am not familiar enough with the SBA loan program that enables the creation of S ESOPs, but we can learn more and get back to your office on that question.

I would say that with respect to risks, ERISA requires sharing a lot of information with would-be owners before they become investors in the company. There is also a fiduciary who is named to be the guardian of the economic interests of the employee-owners. The fiduciary has to act separate and apart from the interest of the sellers. That fiduciary is, obliged under law, to have certain evalua-

tive skills and make decisions that are intended for the best interests of the employee owners and not necessarily in the best interests of the individual or group of individuals who are selling the company.

Ms. ADAMS. Okay. Let me ask in terms of setting up an ESOP, it seems to be quite complex. Can you describe the impact of ESOPs on minority-owned firms and other disadvantage-owned firms? Anyone on the panel. Ms. Silverman, you can start.

Ms. SILVERMAN. I am happy to speak to this but I think others on the panel may have thoughts as well. I would say that it is getting easier. The more the S ESOP model proliferates, the more providers and advisors know about it. While the S ESOP knowledge corps really existed in a handful of cities, it is interesting. We have seen that in the early days of S ESOPs, really, the companies that became S ESOPs sprung up around city hubs where there were a handful of advisors who knew how to do these transactions. Now as the companies proliferate and expand, and as the data show how successful they are, not just for the companies but for the employee-owners who are amassing significant retirement savings, more providers and advisors are becoming aware.

So that there are less hurdles but there are still things to be done. Ranking Member Velázquez noted in her question that there are challenges with SBA rules and there are still things to be done to ensure that a minority-owned business does not lose that special distinction when, and if, they convert to an ESOP. That would be an area we would like to continue to work on.

Ms. ADAMS. All right. Would someone else like to respond? Yes, Mr. Hardy?

Mr. HARDY. Yes. We had some personal experience with that just recently. We are growing as a company. We needed another building to be built on our street, and the first thing I always do is go to the SBA. I have done this in the past. I think we have had three or four SBA loans in the past. When I applied this time, they shut me down and they said, "No, we cannot do that because you are now an ESOP." That was very disappointing. I was very glad to see that H.R. 2096 will fix that problem.

Ms. ADAMS. Yes, sir. Mr. Strange?

Mr. STRANGE. One observation I would make is that as we have worked with minority- and women-owned businesses because we have a goal, because we are company cultured to have inclusion on every project, we are very early in the lifecycle for so many of these businesses. If we look at our spending last year was 20 percent of our total buy, it is a couple of hundred million dollars, but the large majority of those businesses have only been in business for 10 to 15 years. I think there is a maturity issue here. As these companies continue to grow, as their entrepreneurial originators age, if we have these structures around for them to get the education and support, we will see a lot more ESOPs.

Ms. ADAMS. Thank you. You know, Enron's employment retirements were heavily invested in the company, so what lessons and safeguards can be learned from such a failure? Anyone?

Mr. STRANGE. I hate Enron. That is a lesson. What I would observe is what Ms. Silverman said. Bad leadership, bad strategy,

bad ethics cannot be saved by an ESOP. You need the foundation in place if you are going to build a building on it.

Ms. ADAMS. Thank you very much. I yield back, Mr. Chair.

Chairman CHABOT. Thank you. The gentlelady yields back. Before we adjourn, I have one quick question. I think I will direct this at you, Pete. Being in the construction industry, you have a lot of tools and building materials and things like that. I know that there is sometimes a temptation for employees, and things may disappear here and there. With an ESOP, is there an attitude that, hey, this stuff belongs to me, too, all of us? This is my stuff. Is there, maybe, a disincentive for people to do that sort of thing?

Mr. STRANGE. It is dangerous to start me on stories. In the 25 years we have been an ESOP, we have not had a purchase order system. Any employee of Messer can walk into any supplier, and if they are smart enough to rattle off some number as a job number, they can walk out of there with anything. We have had almost zero loss and leakage from that. The feeling of responsibility that this is something that is mine, not something that is theirs, is transformational.

Chairman CHABOT. Thank you very much.

We want to thank all the witnesses for their testimony here. Really excellent. We have heard ample evidence that ESOPs are good for the companies, for their employees, and for the economy as a whole. As a result of hearing this, I would announce that I am going to direct my staff to put me on as a cosponsor of this legislation. We appreciate your testimony very much.

I would ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

If there is no further business to come before the Committee, we are adjourned. Thank you very much.

[Whereupon, at 12:08 p.m., the Committee was adjourned.]

**A P P E N D I X**



WeAreBuilding.

**PETER S. STRANGE  
CHAIRMAN EMERITUS**

**MESSER INC.  
CINCINNATI, OH**

**TESTIMONY BEFORE THE HOUSE COMMITTEE ON SMALL  
BUSINESS**

**HEARING ON "S IS FOR SAVINGS: PRO-GROWTH BENEFITS OF  
EMPLOYEE-OWNED S CORPORATIONS"**

**APRIL 27, 2016**

Chairman Chabot, Ranking Member Velazquez, and distinguished members of the Committee, thank you for inviting me to testify before you today to share my story of inclusive capitalism and the impact it has had upon hundreds of my fellow employees at Messer Construction. Thank you for holding this hearing to learn more about ESOPs and legislation that can encourage more businesses to become employee-owned.

My name is Pete Strange: I began working at Messer Construction as a project engineer back in 1968; and I retired from management a couple of years ago after twenty-three years as CEO. Mine is the tale of two careers. In 1968 Messer was a Cincinnati based, medium size, family-owned construction company with a long history and a good reputation; but like most companies in construction it had little in the way of employee benefits. By 1990 company-funded retirement benefits totaled only \$1,500,000 on behalf of about ninety-nine participants.

In 1988 the last son of the company founder died and we found ourselves with an uncertain future. The grandchildren of the founder wanted access to their wealth and, having no connection with the employees, were not committed to maintaining employment at the company. In 1990 the Messer employees were able to buy their future from the Messer family, using the ESOP structure. I led the employee group through those negotiations, so I can tell you first hand that we employees could not have purchased the company if not for the important tax advantages that the ESOP model afforded us.

Our country's investment in ESOPs allowed ninety-nine Messer employees to purchase our future; and the engagement that opportunity created, has resulted in growth. Today, operating from nine regional offices, Messer performs more than a billion dollars in construction annually, focusing upon health care, higher education, and life sciences projects. And, here is the measure of the change that our ESOP brought to our retirement savings. Messer now provides quality jobs and predictable retirement for over 1000 individuals, and has company-funded retirement assets for those employees totaling more than \$220,000,000.

Through our engagement with the Employee-owned S Corporations of America we have come to know of hundreds of companies with stories similar to ours; and the data from ESCA's quality research shows that ESOP companies are more robust, more sustainable and provide higher levels of diversified retirement benefits than non-ESOP companies. The Messer ESOP is in-place and working well for us; however, Messer manages a vendor supply chain of small local subcontractors who are increasingly at risk from forces both external and internal. Creating a more supportive environment for those companies to form ESOPs, both for the benefit of their employees and to reduce the risk and volatility that results from unplanned succession, will be a direct benefit to our communities, to our customers and to our company as we compete in a global economy.

I have only had one employer in my more than forty year career; but I have had two completely different employment opportunities.

Messer is a clear example of the power of inclusive capitalism that results from supporting Sub S ESOPs. I invite you to visit us or an employee-owned company in your district or state; so you can feel first-hand the pride employee-owners take in their work, and the confidence that employee-owners have in their future.

### **CONCLUSION**

Mr. Chairman and committee members, I thank you for this opportunity to address the committee and share Messer's story, and for your consideration of legislation that will allow more hard-working Americans to share in the American Dream at work.

**Addendum 1 to the Testimony of Peter S. Strange****April 16, 2016****Direct Impact of the Messer ESOP Upon individual Retirement Savings**

The measure of success of any retirement strategy is the replacement income that an individual employee can expect between the age of retirement and the age of death. Peter Strange joined Messer in 1968 as a project engineer and advanced through the company to the position of Vice President, Operations, in 1984. At the end of 1989, after 23 years of service, Pete Strange's company-funded retirement savings would have provided an estimated monthly income (at a 6% annuity rate) of approximately \$250 dollars per month.

The Messer ESOP was implemented in 1990. By comparison, employees who entered Messer as Project Engineers in 1990 and remained with the company through 2015 (twenty-five years) have company-funded retirement savings that would, on the same basis, provide an estimated monthly income of \$5,500 per month.

Three footnotes:

**1.** Both calculations are performed as if the employee retired on the calculation date; while in fact both Pete Strange and the employees joining in 1990 had/have substantial periods of time remaining in their careers, allowing for further growth in their retirement savings. As a result of increased company growth and profitability following the implementation of the Messer ESOP, those additional years would result in a widening of the retirement savings gap.

**2.** The estimated cost of repurchasing retirees' shares is projected into the Messer annual valuation model, assuring that sufficient liquidity will be available when required.

**3.** As a result of the Messer board of directors' actions with regard to dividends, at the end of 2015 the Messer ESOP trust assets include a balanced portfolio investment equaling more than 25% of the value of the allocated Messer shares; providing diversification for the participants and liquidity for share repurchase.

**Addendum 2 to the Testimony of Peter S. Strange**

**April 16, 2016**

**Return on Investment**

**The Positive Economic Impact of America's Support for Employee Ownership**

For decades the US tax code has contained significant support for the creation and success of employee stock ownership plans. In 1998 the tax code was modified to allow ESOPs to own stock in Subchapter S corporations—a significant benefit to further creation and growth of ESOPs. A number of studies have validated and quantified the big picture benefits of ESOPs and compared ESOPs to alternative organization structures. The results of these studies include:

- ESOP companies grow faster, providing higher levels of employment.
- ESOP companies are more resilient, retaining that employment through economic downturns.
- ESOP companies provide company-funded retirement benefits that result in retiree account balances that are materially greater than competing models.
- ESOP companies have a lower failure rate than non-ESOP, private companies, resulting in lower risk to employer backed benefit plans.
- ESOP companies now represent a high level of economic critical mass, driving our national economy forward.

The question remains, “What is the direct return in tax dollars for the investment that our country makes in an ESOP?” This simple study of one ESOP company, Messer Construction, quantifies that positive return.

Messer's ESOP was created in 1990 and Messer became an S Corporation taxpayer in 1998. While there are dozens of variables that might be studied, we have elected to focus upon two straightforward questions:

1. What is the level of investment that our fellow taxpayers made in support of the Messer ESOP?
2. What is the direct return in tax dollars resulting from that investment?

**OUR APPROACH**

We studied the following data over the fifteen year period prior to creation of our ESOP and the fifteen year period following creation of our ESOP:

- Average growth rate as measured by dollars of revenue.
- Average profitability per revenue dollar.

- Average annual employee count, based upon average revenue dollars per employee.
- Average salary per employee.
- Actual retirement account balances in the company-funded retirement plans as of 2004.

After we gathered the data for the two study periods we applied appropriate inflationary adjustments so that all dollars were measured as of 2004, the end point of the study.

We used the following assumptions:

- A corporate federal tax rate of 35%.
- A personal federal tax rate of 25%.
- That, absent the creation of the ESOP, Messer would continue to grow at its historical growth rate during the period between 1990 and 2004.
- That, being an excellent company, Messer would adopt a generous 401k program—100% company match of the first 2.5% of employee savings, resulting in a total 401k contribution of 7.5% per year, per employee.
- That the employer and employee contributions to a 401k would be tax deductible.
- That funds held in trust, whether in the ESOP or the 401k plan would grow at at-least the rate of inflation, after 2004.

## OUR RESULTS

**Investment received through tax deferral: (\$14,203,345)**

**Additional taxes paid:** \$41,807,481

**Net benefit in federal taxes:** \$27,604,136

**A multiplier of 2.94 in same year dollars!**

## THE MATH:

### Question 1: The tax investment:

For the sake of consistency, we have analyzed the data as if Messer and the Messer ESOP had been the beneficiaries of the full ESOP benefits, including the S Corporation tax deferral, beginning in 1990. All calculations have been normalized to 2004 dollars—the end of the study period.

Messer was a profitable, growing company over the fifteen years prior to forming its ESOP. The result of the positive tax code benefits for ESOPs is that Messer's income tax payments would be deferred until participant retirement. Over the fifteen years prior to 1990, Messer revenue grew at an average annual rate of 2.26% over inflation. Projecting continued growth and profitability at that rate for the fifteen years following formation of its ESOP, and assuming that Messer implemented a strong 401k retirement plan, the calculated tax deferral would have resulted in an investment by US taxpayers of \$14,203,345 in 2004 dollars.

### Question 2. Direct return in federal taxes paid—or to be paid.

With the implementation of our ESOP Messer's growth trajectory changed. Over the fifteen years following creation of the ESOP Messer grew at 5.76% over inflation. The marginal growth driven by our ESOP resulted in employment growth of an additional 233 employees over the fifteen year period. Applying the calculated average gross pay to those employees as they entered the payroll, and applying the assumed individual tax rate to those marginal employee earnings results in additional federal tax payments of \$38,719,967 in 2004 dollars.

The actual account balances for the Messer retirement plans at the end of 2004 totaled \$71,036,326. The calculated total balances in 2004 for a 401k plan that would have resulted from the pre-ESOP growth rate in employment and the assumed total annual contributions of 2.5% from the company and 5% from the employee would be \$58,686,273. With the assumption that the funds held in either trust would grow until retirement and mandatory withdrawal at at-least the rate of inflation, the federal government will receive tax at the assumed personal rate on the difference between the two trust funds, or \$12,350,053. At 25% personal tax rate the result is additional federal tax payments of \$3,087,513 in 2004 dollars.

Adding the two sources together results in total calculated additional federal taxes resulting from the Messer ESOP of \$41,807,481 in 2004 dollars.

#### **CONSERVATISM IN THE CALCULATIONS:**

The two direct tax sources calculated above materially understate the actual benefits of the ESOP to our local, state and national economies. Additional metrics that could be added include:

- The multiplier effect of the added spending by the additional employees, resulting in additional federal tax from the profit on their purchases.
- The savings in federal benefit costs post-retirement resulting from the more robust ESOP retirement accounts.
- The taxes received at the state and local level as a result of the additional employees and their post-retirement spending.
- The fact that hundreds of employees who receive robust retirement benefits will spend far more post-retirement as compared to receiving the 401k level benefits.
- The fact that the ESOP is fully funded by the company, resulting in all Messer employees, at every income level, having a marginal 5% (the employee contribution to the 401k) to spend during each year of employment.
- The fact that Messer has continued to grow, resulting in ever more employment, ever more retirement benefits—and ever more federal income tax payments.
- The fact that, since 2004, the Messer ESOP has actually grown at a rate more than double the rate of inflation, which will lead to tax payments by participants at withdrawal far greater than those indicated in 2004.

- The fact that Messer has in place, alongside its ESOP, a substantial, voluntary 401k retirement plan, not included in our retirement savings calculations.
- And many more benefits at both the enterprise level and at the employee level.



## Testimony before the U.S. House Committee on Small Business

Jay Hardy  
President, Hardy Diagnostics  
In support of H.R.2096  
April 26, 2016

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### Oral Testimony – Jay Hardy

First of all, I would like to thank Chairman Chabot today for inviting me to voice my support of H.R.2096 and the proposed incentives to increase Employee Ownership in America. I would also like to thank Ranking member Valazquez and the other members of the Small Business Committee.

My name is Jay Hardy. I am the President and founding partner of Hardy Diagnostics, a medical device manufacturer based in California with a manufacturing facility in Ohio and Texas. We have been in business for 36 years serving the laboratory industry and currently have 350 employees.

Four years ago, I sold 70% my shares to our newly formed ESOP (Employee Stock Ownership Plan). Last year I sold the remaining shares, making our company a 100% employee owned S Corporation. I have never had any regrets in making this decision, which has set our company on a course of increased growth and prosperity for the reasons that I would like to describe for you today. Since becoming an ESOP our company has grown by 78%. The numbers speak for themselves.

The ESOP structure was defined by Congress as a part of the ERISA laws in

1974. Just as the Abraham Lincoln's Homestead Act of 1862 created wealth for ordinary citizens by granting them 160 acres of land, the ESOP also has the potential to create wealth for all Americans without having to own land. Within the ESOP, employees are granted shares of the company they work for without cost or taxation. Currently there are over 11 million ESOP participants in America. This number needs to grow.

Recent studies have shown that:

1. ESOP companies are 25% more likely to stay in business than non-ESOPs.
2. Employee Owners were four times less likely to get laid off during our last recession.
3. Employee Owners have 2.5 times more money in their retirement accounts than non-ESOP employees
4. Employee Owners receive 5 to 12% more in wages than non-ESOP employees.
5. Employee Owners are 5 to 10% more productive than their non-ESOP counterparts.

So you can see that ESOPs are undoubtedly a very good thing for the American worker, and thus good for the overall American economy.

Today we hear a lot of talk about income inequality and capitalism being good only for the privileged 1%. Why can't capitalism be accessible for all American workers by owning a portion of the companies that they work for? While capitalism may have its flaws, the modern ESOP provides a way to correct those flaws. This is why the ESOP has been nicknamed "Universal Capitalism" or "Capitalism for the Masses."

The Employee Owner turns out to be highly motivated, because they know that their efforts will be directly rewarded through an increase in share value. This in turn makes the American ESOP more able to successfully compete in a world market.

Today many workers are afraid that Social Security or their meager 401(k) savings will not be adequate for their retirement. The ESOP will substantially supplement those retirement programs in a significant way.

The original idea of Employee Ownership came from Luis Kelso, who formed the first ESOP in 1956. He once said, "*The trouble with today's finance is that they're designed to make the rich richer. None is designed to make the poor richer.*" He also said "*If capital ownership is good for the rich, it is a thousand times better for the middle class and the poor.*"

The workers at Hardy Diagnostics now know that their daily work is not drudgery, but rather an exciting investment in their financial future.

In preparation for this testimony, I asked the Employee Owners of our company to provide me with their thoughts about the ESOP which they own. One of them said, "*Since becoming an ESOP, I have found an avenue in which every employee has an opportunity to be engaged in the company's steady climb of growth. As a manager, nothing is more rewarding than seeing individuals in my department with such a high level of enthusiasm for the success of our company, as well as their own personal growth and achievements.*"

Another Employee Owner said, "*Being a part of an ESOP breaks down title barriers. We all have the same title... OWNER. Ownership inspires greater value and satisfaction in our daily work. Our work turns into an investment. It is no longer just a job.*" I think you get the idea...

H.R.2096 is an excellent piece of legislation that provides incentives for S Corp business owners to create an employee ownership program. This will make the S Corp ESOP a very attractive exit plan for business owners that wish to do the "right thing" in turning the ownership of their companies over to the

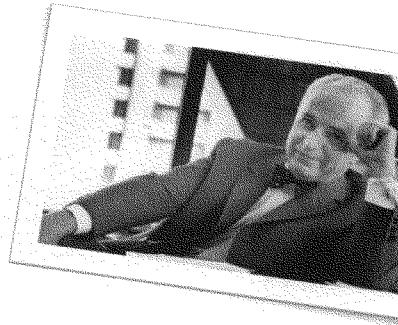
workers that made their business successful. H.R.2096 also provides incentives for banks to loan the funds that make this transaction possible.

Those that study history know that socialism and its close cousin communism don't work. They rob the worker of incentive and the rewards that could be theirs. Winston Churchill once said, "*Socialism is a philosophy of failure, the creed of ignorance, and the gospel of envy, its only inherent virtue is the equal sharing of misery.*" Capitalism

for all its flaws remains the best system the world has ever known. Let's improve upon it, by putting true ownership within the reach of all American workers through the wealth building program of the modern ESOP.

I'm passionate about employee ownership and I enjoy being an evangelist for the ESOP movement in America. I thank you once again and would be glad to answer any questions that you may have.

# Employee Ownership



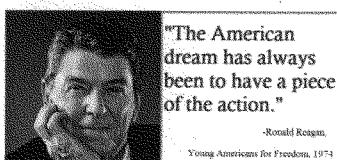
*As described by Luis Kelso – originator of the ESOP and “Universal Capitalism”*

By Jay Hardy

## The man who created 11 million capitalists...

Louis Kelso was born in Denver in 1913. Because he grew up during the Great Depression, he was acutely aware of capitalism's occasional failings.

While serving in the Navy during WWII, he dreamed of creating a way in which the common worker could share in building wealth through corporate ownership. In 1956, Kelso enabled the employees of a newspaper company in Palo Alto, California, to buy out its retiring owners through a new financing concept. Thus, Kelso created the “Employee Stock Ownership Plan” (ESOP), a new sort of “capitalism for the masses.”



Thanks to this financing technique, working people, without much in the way of savings, were able, for the first time, to obtain stock in their company and pay for it out of the company's future dividend yield. Thus, this ESOP was the prototype for many leveraged buy-outs to come, which would offer real shares to workers at no personal cost.

What Kelso was aiming for was to democratize access to capital credit for the benefit of the common worker. He called this “Universal Capitalism.” His first book, co-written with Mortimer J. Adler and published in 1958, was playfully named *The Capitalist Manifesto*. In 1968, he and his wife wrote another book, *How to Turn 80 Million Workers into Capitalists on Borrowed Money*.

Kelso considered the success of the ESOP as pragmatic proof that his revolutionary

financial techniques were sound and workable in today's economic and business world.

He further believed the business corporation was society's greatest social invention and that its executives had a fiduciary responsibility to exercise its vast power for the good of society.

Kelso long believed he had not originated a new economic theory but only discovered a vital fact that classical economists had somehow overlooked. This fact was the key to understanding why private property and free market economy were notoriously unstable, pursuing a roller coaster of exhilarating highs and terrifying descents into eventual economic and financial collapse.

Technological change, Kelso concluded, makes tools, machines, structures, and processes ever more efficient while leaving human productivity largely unchanged. The result is that primary distribution through a free market economy delivers progressively more market-sourced income to capital owners and progressively *less to workers who make their contributions through labor*.

In an effort to build wealth amongst its citizens, Abraham Lincoln signed into law the Homestead Act of 1862. This law granted the opportunity for ordinary Americans to become owners of up to 160 acres of land at no cost to them. Obviously, we can no longer give away free land. However the modern ESOP, which has been aptly nicknamed "The Industrial Homestead Act," can help the common worker to fulfill their dreams of capital ownership, just like Americans did in the 1800s.

Something has gone awry since then. It's alarming that Pew research has uncovered the following trends in income disparity in the US from 1971 to the present:

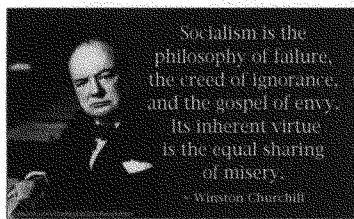
- The middle class (median income of \$73,400 now) has declined from 61% of adults to 50% today.
- The upper class (median income of \$174,600 now) has climbed from 14% to 21%.
- The lower class (median income of \$24,074 now) has also risen from 25% to 29%.

It's staggering to think about the social unrest and other dire consequences should this trend continue in the future. Kelso has ingeniously offered a viable solution that is capable of reversing this trend.



The symptoms of dysfunction are capital concentration within a select few, income inequality, and, thus, inadequate consumer demand. These effects translate into poverty and economic insecurity for the majority of people who depend entirely on wage income and cannot survive more than a week or two without a paycheck. Also, as Adam Smith declared, since economic demand begins with the consumer and consumer purchasing power, the production side of the economy is under-nourished and hobbled.

We all know that socialism and its more draconian cousin communism have failed miserably again and again throughout history. It saps the incentive and motivation that is needed for innovation and advancement. Instead of tossing capitalism with all its faults into the trash can of history, why not perfect it and make it more accessible to the common worker?



Now, at the beginning of the 21st Century, interest in Louis Kelso's economic thought is on the rise. Economists now admit they do not understand economic growth—how to stimulate it in poor countries or how to restore the “magic” at home after it has gone. They cannot explain the economic decline of the middle class. Most unsettling, they still do not understand the cause of a depression, nor do they know how to prevent the next one. Not long ago, Lester Thurow, a famous economist, admitted without apology, “*Economic collapses are an intrinsic part of capitalism.*” Kelso believed that this can be fixed.



If Kelso is right, private property free market principles can be used to correct the faults of the market economy. ESOPs distribute income to the workers as

efficiently as it produces it: creating stability while expanding economic growth and creating new markets and more customers. All this can be accomplished without a forced redistribution of wealth *and without sacrificing our constitutional guarantees and freedoms.*

In conformance with the private property/free market principles identified by Smith and his followers, all of Kelso's financing tools and economic proposals are designed to correct the imbalance between production and consumption *at its source.*

**Therefore, the modern ESOP is an excellent way to correct the ever increasing imbalance of wealth that persists in America today without forcing a socialistic redistribution of wealth.**

*What are the ultimate benefits of employee ownership?*

- Accumulation of wealth beyond mere wages
- Increase in productivity, motivation, and competitiveness
- Greater harmony between labor and management – a unified purpose
- Broad ownership of capital that is available to all – not just a few
- Sustainable and secure jobs
- Stronger belief in the free enterprise system



*“Socialism has been discredited. Plutocracy (rule by the wealthy) is in the process of being discredited. Democratic capitalism has yet to be tried.”*

### *Famous Kelso Quotes...*

*“If capital ownership is good for the rich, it is a thousand times better for the middle class and the poor.”*

*“We have an economic policy that is just about 10,000 years out of date!”*

*“The trouble with today’s techniques of finance is that they’re designed to make the rich richer. None are designed to make the poor richer. That’s why the poor are poor; because they’re not rich.”*

*“When capital owners are few, the private property conduits of necessity create vast savings reservoirs for those few. If there were many owners, the same conduits would irrigate the economy with increased purchasing power.”*

*“People are hungering for property — for a secure, permanent and independent link with spaceship earth that ownership represents and which only ownership can protect or defend. It is humiliating to possess nothing, to own nothing and hence to produce nothing and to count for nothing.”*

*“What the economy needs is a way of legitimately getting capital ownership into the hands of the people who now don’t have it.”*

*“America must rethink the meaning of democracy and set about within its borders to rationalize its economic policy into one that synchronizes the shift from labor intensive to capital intensive production, with universal capital ownership and the payment of the full wages of capital to capital owners, so to restore economic democracy to our economy. We should democratize our plutocratic capitalist economy before we preach democracy to others.”*

*“The Roman arena was technically a level playing field. But on one side were the lions with all the weapons, and on the other the Christians with all the blood. That’s not a level playing field. That’s a slaughter. And so is putting people into the economic arena without equipping them with capital, while equipping a tiny handful of people with hundreds and thousands of times more than they can use.”*

*"There is no future for those who cannot or will not think."*



## EMPLOYEE QUOTES REGARDING OUR ESOP

### *What Employee Ownership Means to Me...*

*Hardy Diagnostics is a medical device manufacturer that operates production facilities in California, Texas, and Ohio. The company was founded in 1980 and has been an ESOP (Employee Stock Ownership Plan) since 2012. The company has grown by 78% since becoming an ESOP. About 300 of its 350 employees own shares in the company through the ESOP program. When the Employee-Owners were asked what owning a business means to them, this is what they said...*

"Being a part of an ESOP breaks down title barriers. We all have the same title... **OWNER**. Ownership inspires greater value and satisfaction in our daily work. That work turns into an investment. It is no longer just a job." – *Rebecca Richards, Accounting Manager*

"One of the most rewarding experiences a person can participate in is ownership of property, professional growth, and destiny." – *Mark Widde, New Product Specialist*

"Being an owner of Hardy Diagnostics gives me a sense of security about my future and eventually my retirement." – *Chuck Williams, Regional Territory Manager*

"...my initial thought is that I don't feel I represent some large, nameless corporation. The fact that I am an owner is all over our website and our paperwork that our customers see. So when they call me on the phone, they know I am an owner. I don't represent some big faceless corporation, I represent ME. I'm not a powerless drone that can pass off the blame for a bad experience. I am responsible for that customer's experience and responsible for fixing it,

on MY reputation. That is a very strong motivator for me." – *Kate Massey, Technical Support Specialist*  
 "Since becoming an ESOP I have found an avenue in which every employee has an opportunity to be engaged in the company's steady climb of growth. As a manager, nothing is more rewarding than seeing individuals in my department with such a high level of enthusiasm for the success of our company, as well as their own personal growth and achievements." - *Joe Cortez, CA Distribution Center Supervisor*

"For me, it's all about my outlook. I used to come to work and talk about the direction the company was going—as if it were controlled by someone behind a curtain—or used divisive words like "they" or "he." Now, I realize as a co-owner of Hardy Diagnostics, I have a huge stake in the outcome. Today, I used the terms "I" and "we." I know I can help steer this mighty ship that helps save the lives of Americans and people around the world every day. That's something that makes all of "us" owners very proud. Having just received the biggest profit sharing check since I started work here nine years

ago, it's hard not to think about how the ESOP is making Hardy Diagnostics—my company—more profitable. I'm able to use this money to sow back into my community through charitable giving. I can't wait for the harvest my humble seeds of generosity will reap." – *Dan Theisen, Manufacturing Systems Manager*

"Since becoming an owner of Hardy Diagnostics, I have gained a better understanding of how my work impacts our company's profit. I am motivated to work hard to contribute to the value of our company stock and my retirement plan. I am happy to work for a company that shares the company profit with the employees who produced that profit." – *Sue Priett, Director of Quality Assurance*

"ESOP provides individuals with a sense of ownership and representation of something greater than themselves. It is not only a means for financial gain, but individual growth as well. As owners we must learn about financials and successful business practices. We now must put our best foot forward to ensure the longevity of the company, which in turn assists with economic health. It is a 'Win Win!'" – *Honey Hoe, Document Control Manager*

"When you are both an employee **and** an owner you can really affect the bottom line for yourself and the company." – *Steve Smith, Ohio Distribution Center Supervisor*

"In this day and age where the American dream has been seemingly held just outside the reach of the middle class, the ESOP has become a beacon of hope. It renews the mentality that if you work hard as an individual and together as a company, everyone has the opportunity to earn the financial stability that was once common place. In a world where the "home with a white picket fence" has grown more difficult to attain, ESOP's have provided me the chance to not only be proud of what I do and who I work for, but has also provided me with the ability to provide for my family as it continues to grow. I would much rather work for a company who considers each member a crucial part of the team, rather than a conglomeration of nameless faces who are worth nothing more than a

means to generate profit." – *Daniel Ballew, Marketing Associate*

"Becoming an owner has motivated me to do my very best work, so that the company will succeed. It gives me a sense of having control over my own destiny, and fills me with a sense of pride. It provides my family an extra layer of financial protection." – *Chris Catani, Director of Sales and Marketing*

"ESOP: The fight for the American dream in an instant. God bless America." – *Mary Kelly, OH Distribution Center Clerk*

"After reflecting on what the Hardy Diagnostics ESOP means to me and my family, the first thing that came to mind was the "American Dream" for which I found the following description: "*The ideal that every US citizen should have an equal opportunity to achieve success and prosperity through hard work, determination, and initiative.*" This is exactly what the Hardy ESOP provides. As a Hardy partner I have the ability every day to directly impact the performance of our business, the loyalty and quality of our products, our company brand and finally the valuation of our business. This in turn directly impacts my family's financial security today and tomorrow, which I can simply describe as financial peace of mind, and that is a beautiful thing. When people ask me what I do, I am proud to say I am a business owner of a company that helps save lives." – *Robert Meijer, National Sales Manager*

"Thanks to the ESOP our family knows that we can look forward to staying in business with a company that already has been successful for the last 30 plus years. We feel secure and our future ahead looks bright when retirement comes. Thank you, Jay, for thinking of your employees. My family will always be thankful to you all their lifetime. I enjoy coming to work every day working for an employer that I know cares about his workers." – *Eduardo Cuna, Manufacturing Cook II*

"Being a partner in the business means lots more than just getting a paycheck. Anything I can do to help, improve or solve a problem directly affects my business partners and my family. In looking ahead to my retirement, I will see the difference that our individual contributions have made. It feels great to be in a successful partnership." — *Allen Millikan, Maintenance Technician*

"I've always been told that Social Security will no longer exist by the time I reach retirement age. Now, thanks to our ESOP program I have confidence knowing that every day I am working towards a financially secure future; one where I will be able to afford retirement without having to rely on a tenuous governmental support system. At Hardy Diagnostics we're all very proud of our ownership, and knowing that we all have a stake in the company's outcome makes everyone pull together even more to achieve our goals and accomplishments. Holding our financial future in our own hands is an empowering and amazing experience, and it is a great feeling to interact with one another as **co-owners** rather than as **co-workers**." — *Wendy Hadley, Quality Control Manager*

"An ESOP provides me and my family with an opportunity for a better financial future. I am not left to work all my life and wonder if social security will be enough or even be there. Working hard every day affects the bottom line of any business but with an ESOP that bottom line is my family's future." — *Eddie Yubeta, Customer Service Manager*

"I feel like the ESOP brings a sense of community to our company. We are all in this together for a common good. For my family, I feel it brings security to our future in these very uncertain times we live in with no hope for social security, etc." — *Kathy Stellar, Regional Territory Manager*

"You can quote me as having a household of ESOP workers. At my husband's work, Okonite, which made the cable that goes from mainland to the Statue of Liberty, has been a very successful ESOP

since June 1976. Chuck has been working there for 33 years." — *Joan O'Hern, Document Scanning Technician*

"Becoming an ESOP company has definitely changed our culture - and for the better! Since we are now all owners of the company, departments communicate and work towards a common goal more effectively. That unity of purpose improves the health and viability of our company and facilitates our future growth plans." — *Kimball Lombardi, Director of Manufacturing*

"Not only did becoming an owner motivate me to come to work and give my 100%, but it also provided peace of mind for my retirement in the long run. Thank you, Jay." — *Gilberto Zarate, Manufacturing Cook II*

"Becoming a Hardy Partner has enabled me to set an example to my daughter. Being part owner of something with such a great cause definitely gives you a sense of self-worth. It is truly a "**hand up**," as oppose to a hand out; which only keeps you at a distance from attaining what the American Dream use to be." — *Shirley Del Remedio, Customer Service Representative I*

"Being a part of an ESOP company like Hardy Diagnostics is a trailblazing experience!" — *Nathan Bowersock, OH Distribution Center Manager*

"This year I joined my husband Pete, and became an ESOP partner. Now, Pete and I are both owners of Hardy Diagnostics. It doesn't get any better than that." — *Rosa Prendergast, Packaging/Labeling Production Technician*

"As my wife and I begin to think more seriously about retirement planning, we find ourselves counting up the various sources of retirement income that we will draw on—401(k) and IRA accounts, possible inheritance from our parents, Social Security and the like. The results have not been comforting. Enter the Hardy Diagnostics ESOP. In just four short years, the value of my Hardy ESOP account is beginning to approach the combined value of our 401(k) and IRA accounts and

will likely surpass these sources in just two more years. This has us breathing a lot easier!" – *Mike Welch, Director of HR*

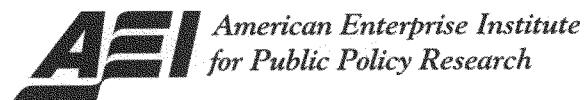
"During my professional career, I have worked for three companies, one public company and two ESOP companies. I would choose an ESOP company over any other company, hands down. Since I don't know if Social Security will be there when I retire, it is comforting to know my Company and my co-workers are all working towards a common goal...to grow the Company and the bottom line, which in turn increases the ESOP stock price and therefore adds to all of our retirement funds. We all benefit! I am so proud to say I own a piece of the Company that I work at each and every day. When I tell individuals outside of the Hardy family about the ESOP and how it benefits not only the Company but also all the employees, those individuals are so intrigued they want to hear more. Then at the end of our conversation, I usually hear..."Let me know if they ever need someone with my skill set." They want to be owners as well."

– *Darla Prevish, Chief Financial Officer*

"My name is Steve Stuart. I work in the sales and marketing department of Hardy Diagnostics as a videographer and package designer. I was previously employed at a sporting goods retailer as their advertising director. I was with this firm for 20 years. In 2004, the owners of the company decided to sell so that they could pursue other ventures. Since this was a family owned business, the owners wanted the company they had built, and which bore their name, to continue and prosper. To that end, they searched for a buyer to satisfy this goal. They found a company based in New York that had acquired and successfully run several retail businesses. Once the sale was complete, a new CEO and CFO were brought in to run the business. Within two months of this event, my position was eliminated. The new CEO decided to run all advertising through an out-of-house advertising agency. By 2006, because of mismanagement, the company filed for Chapter Eleven and was forced to close after almost 35 years in business. Employees at over 30 stores in four states, two distribution centers, and the corporate office, ended up without

jobs just like me. As for myself, I struggled to find long term, full time employment for five years. Being hired and working for Hardy Diagnostics has been a Godsend. I have never worked for a better company or one that does such important work. We make products that save lives! When I learned that our company president Jay Hardy was planning on selling the company he built to his workers as an ESOP, it caused me to sigh with relief! Jay was insuring not only the future of Hardy Diagnostics; he was insuring the future of us who work here. And with the stock we all share as employee owners, it's not just our jobs that are secure; we have a constantly growing resource that will be available to us upon retirement. When Hardy Diagnostics prospers, we prosper! If my old company had become an ESOP, it would still be here today." – *Steve Stuart, Graphic Designer/Videographer/Packaging Specialist*

"Since we became an ESOP corporation I have found it very much easier to assume a leadership role with my colleagues, when needed, due to the fact that they know I am not interfering with them or their work but rather I am assisting them to do what we all want, which is to improve the company's performance." – *Derek Tinsley, Chemist*  
 "I think becoming an owner of this company would mean a lot to me! First of all I would take pride in my work knowing that what I am doing is going towards a great cause and that someone will be affected by our products. Now, every time I come home I talk to my parents and family about how working here is such an enjoyment and I am always bringing up what we produce, where our products go, and how it will affect the lives of others. Working here has showed me that one person can make a difference, and from our stance, a company can really make a difference!" – *Kevin Good, CA Distribution Center Clerk*



Statement before the House Small Business Committee  
On  
S is for Savings: Pro-Growth Benefits of Employee-Owned S Corporations

Alex Brill

Resident Fellow

American Enterprise Institute

April 27, 2016

*The American Enterprise Institute for Public Policy Research (AEI) is a nonpartisan, nonprofit, 501(c)(3) educational organization and does not take institutional positions on any issues. The views expressed in this testimony are those of the author.*

Chairman Chabot and Ranking Member Velázquez, thank you for the opportunity to appear before the Small Business Committee to discuss the role of S ESOPs in the US economy. My name is Alex Brill, and I am a resident fellow at the American Enterprise Institute, a think tank in Washington, DC.<sup>1</sup> In my testimony this morning, I will address four questions:

- What is an S ESOP?
- What are the trends in S ESOPs' economic performance?
- How are S ESOPs good for small business?
- How are S ESOPs good for the US economy?

The key conclusions of my testimony can be summarized as follows:

S ESOPs, which are defined contribution retirement plans that allow employees to become owners, are increasingly popular in the US. As a complement to a diversified portfolio of retirement assets, S ESOPs can improve the well-being of workers and the productivity of firms by strengthening employee commitment. S ESOPs exist across a wide spectrum of industries and include a meaningful number of US employees. As the US seeks to rebound from a period of tepid productivity growth, tools such as S ESOPs can improve worker commitment, reduce worker turnover, and lower production costs. In addition, S ESOPs proved resilient in the face of the most recent recession and thereby helped mitigate the adverse effects of the recession on S ESOP suppliers and related business activity.

#### **What Is an S ESOP?**

An employee stock ownership plan (ESOP) is a type of defined contribution retirement plan that must invest primarily in employer securities. Since 1998, chapter S corporations have been permitted to sponsor an ESOP, commonly referred to as an S ESOP. S ESOPs offer a myriad of benefits to employers and employees in the realms of tax, financing, and retirement security. The structuring and operations of S ESOPs are governed by numerous rules and regulations, many similar to the governance of other tax-qualified retirement plans such as 401(k) plans. For example, S ESOP participation must be broadly available to employees over the age of 21 with at least one year of service, and the plan must not discriminate in favor of "highly compensated" employees. Other complex regulations dictate allocation rules, anti-cutback rules, and record-keeping requirements generally. An S ESOP can own as little as 5 percent of the equity and as much as 100 percent of a business. S ESOPs with 100 percent ownership are commonplace, while S ESOPs with a minority share are relatively uncommon.

While the legal and regulatory issues related to S ESOPs are important, this testimony will focus on the economic effects of S ESOPs and in particular the effects of employee ownership on employee commitment, firm productivity, and firm resilience.

#### **What Are the Trends in S ESOPs' economic performance?**

Before delving into the economic evidence with respect to the effect of S ESOPs on the welfare of employees and the success of firms, it is important to recognize the depth and breadth of S ESOPs in the

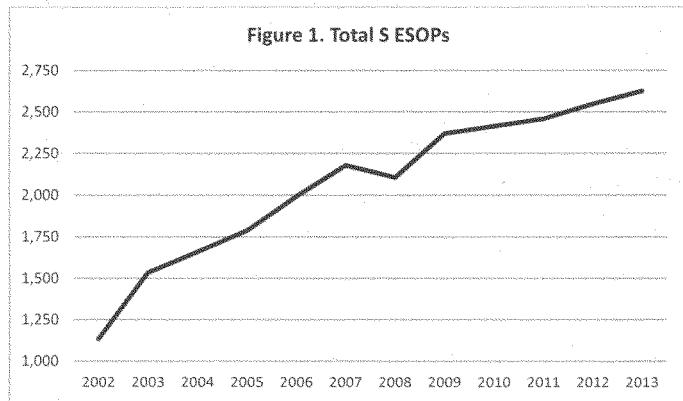
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<sup>1</sup> Previously, I served as the chief economist and policy director to the House Committee on Ways and Means and on the staff of the White House Council of Economic Advisers. In addition, I have previously consulted to S ESOPs through their trade association. The views expressed here are mine alone and may not reflect the views of my employer, the American Enterprise Institute (AEI); my colleagues at AEI; or any entity to which I am affiliated or to whom I have consulted.

US economy. The data presented next represent the most current evidence of S ESOPs in the US based on Department of Labor (DOL) Form 5500 filings, which provide information about employee benefit plans, including whether a company has an S ESOP, total active participants, the number of retired participants receiving benefits, and the industry in which the firm operates, among other statistics. Using these data, I am able to narrow in on only S ESOP firms.

In previous research, I analyzed Form 5500 data from 2002 through 2009. Here, my analysis is updated through December 31, 2013.<sup>2</sup> The advantage of incorporating newer data is twofold. First, newer data provide the most current indication of the size and scope of S ESOPs in the US economy. Second, additional years of data permit for a more robust comparison of the performance of S ESOPs following the recession of 2007–2008.

Figure 1 shows the number of S ESOPs in the US for each year from 2002 through 2013 using the methodology noted in footnote 3.<sup>3</sup> The number of S ESOPs has increased 131 percent, from 1,135 in 2002 to 2,626 in 2013. In general, the increase has been steady year-over-year, though there was a 3 percent dip in the number of S ESOPs in 2008.



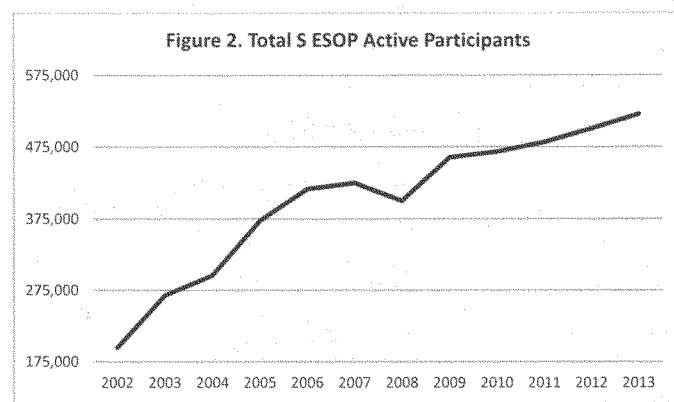
Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

More important than the steady increase in the number of S ESOPs is the increase in the number of employee owners working at S ESOP companies. As Figure 2 shows, from 2002 through 2013, the number of active participants at S ESOPs increased 167 percent, from 195,000 in 2002 to 521,000 in 2013. During the 2007–2008 recession, active participants declined almost 6 percent. However, this

<sup>2</sup> DOL does report Form 5500 data for 2014 and 2015. However, these files are incomplete.

<sup>3</sup> DOL's Form 5500 data contain observed duplicates (and triplicates) of filings for the same business as well as filings for firms with fewer than 15 active participants. As described in Brill (2012), the data reported here reflect the removal of duplicate filings based on the reported employer identification number (EIN) and the removal of firms with fewer than 15 active participants. If duplicate forms reported conflicting, non-zero data with respect to the number of active participants, the results were averaged.

drop was reversed by 2009, while the decline in US employment lingered into 2014. Since 2008, active participants in S ESOPs have increased 30 percent. It should be noted that, because not all employees are necessarily S ESOP owners,<sup>4</sup> the number of active participants in S ESOPs is a conservative estimate of employment by these firms. Brill (2012) compared active participants from DOL Form 5500 data with firm-level survey data for a sample of S ESOP firms and found that actual employment averaged 40 percent higher than active participant numbers. If those survey results are generalizable to the entire S ESOP sector, total S ESOP employment would exceed 725,000 for 2013. While conservative, active participant data represent a reliable indicator of the trend in employment over time.<sup>5</sup>

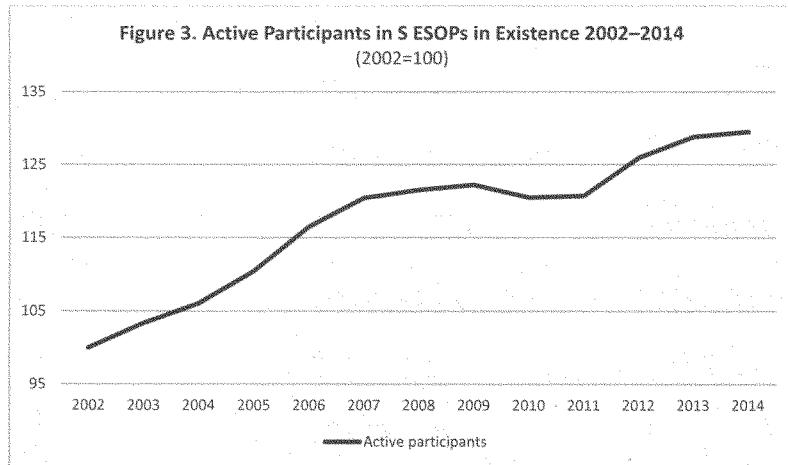


Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

Some of the growth in S ESOP employment is attributable to firms hiring more workers, and some of the growth is attributable to the rising popularity of S ESOPs generally. In other words, the large increase in S ESOP employment from 2002 through 2013 does not entirely represent organic growth in jobs within S ESOPs; it also reflects firms converting to S ESOPs. To disentangle these two drivers of S ESOP employment growth, Figure 3 presents results from a subset of S ESOPs: firms that existed in 2002 and continued to exist every year through 2014. Within this subset of S ESOPs, active participants increased 30 percent during this period.

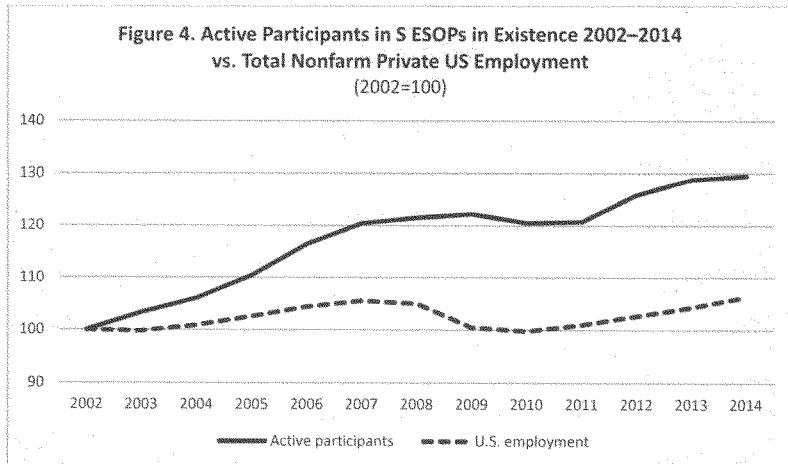
<sup>4</sup> Part-time workers, workers younger than 21, workers with less than one-year of tenure, and unionized workers may be excluded from S ESOP participation.

<sup>5</sup> The Brill (2012) analysis of the reliability of active participant counts as a proxy for employment also indicated that changes in the number of active participants were highly correlated with changes in the reported number of employees.



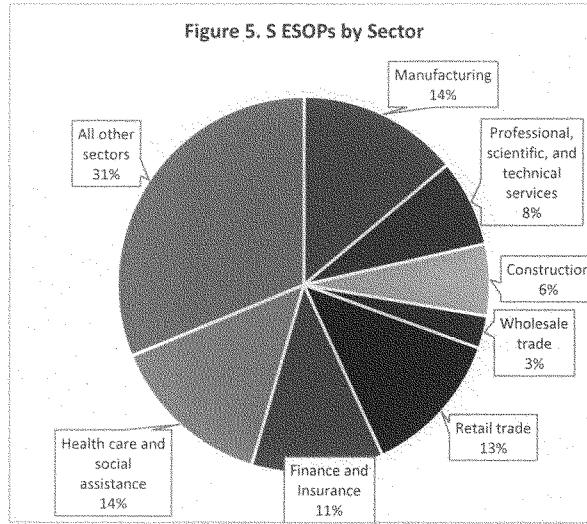
Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

To put the growth of S ESOPs in context, Figure 4 presents the annual change in US employment and S ESOP active participation, normalized to 100 in 2002 for the same subset of S ESOPs in Figure 3. Unlike overall employment that dropped from 2008 through 2010 and only regained its historic level in 2014, employment at this subset of S ESOPs only plateaued through the recession before increasing 8 percent from 2011 through 2014.



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

S ESOPs exist across a broad spectrum of US industries. In total, DOL data indicate that S ESOPs exist in 20 unique industries. The biggest seven industries for S ESOPs, ranked by the number of active participants, are health care and social assistance, manufacturing, retail trade, finance and insurance, professional services, construction, and wholesale trade. Collectively, these represent 69 percent of all active participants in 2014 for which there are data. Figure 5 illustrates the share of active participants in each industry.



Source: Department of Labor, Form 5500 data, accessed April 20, 2016.

#### How Are S ESOPs Good for Small Business?<sup>6</sup>

ESOP firms, including S ESOPs and C corporation ESOPs, have been shown to perform better than non-ESOPs by a number of metrics. For example, a 2000 study by Douglas Kruse and Joseph Blasi of Rutgers University finds that ESOP companies enjoy greater longevity as well as 2.3–2.4 percent higher sales, employment, and sales per employee annually than would otherwise have been anticipated (NCEO 2012). Kruse (2002) finds that “productivity improves by an extra 4–5% on average in the year an ESOP is adopted, and the higher productivity level is maintained in subsequent years. This one-time jump is more than twice the average annual productivity growth of the U.S. economy over the past 20 years.” Park, Kruse, and Sesil (2004) find higher survival rates among ESOP companies compared with non-ESOP companies.

The way in which S ESOPs improve firm outcomes is likely multifaceted, but one clear channel is by improving employee commitment. Employee commitment has been found to be a driver of job satisfaction, motivation, and attendance (Becker et al. 1996). Kloys (2001) finds that positive employee

<sup>6</sup> This section draws, in part, from Brill (2012).

attitudes and behaviors lead to positive business outcomes (i.e., profitability and customer satisfaction). Other studies have shown that loyal employees work with greater efficiency than uncommitted workers. For example, Green (2008) finds that loyal employees do not require as much supervision and notes, “It therefore profits employers to allow employees some leeway in their jobs. But . . . leeway permits self-interested employees to take advantage and work less hard. Autonomy can be more effectively granted, therefore, to those workers who are less likely to behave opportunistically—that is, those whose preferences are to identify with the company’s objectives, share its values and to show loyalty.”

Firms with loyal employees incur fewer expenses because turnover is low. Mathieu and Zajac (1990) and Meyer et al. (2002) confirm that organizational commitment among employees is negatively correlated with turnover, meaning that turnover is low among committed employees. Brown et al. (2011) examine the effect employee attachment has on workplace performance and find that “in so far as employees who exhibit commitment and loyalty towards their employer may have interests which are aligned with those of their employer, the agency costs often associated with the employee-employer relationship are reduced.” These positive effects of employee commitment, including worker efficiency and lower operations costs, lead to increased profitability, which in turn allows companies to grow at a faster rate because they can invest more, hire more workers, and increase output.

Thus, ESOPs tend to perform better than their peers, and the mechanism by which this occurs is – at least in part – an improved alignment of incentives and additional commitment of effort and dedication by workers. This is particularly important in the small business context. The economic success of small and medium-sized enterprises (SMEs) is often reliant on the ability of firms to ensure that employees work effectively and cohesively for the common good of the business. A high degree of worker commitment and low rates of worker turnover are key components for SMEs’ success in an increasingly competitive global marketplace and an often increasingly competitive local marketplace.

#### How Are S ESOPs Good for the US Economy?

The benefits of S ESOPs are not limited to just S ESOP firms and their employees. As Figures 1–5 above show, S ESOPs are quite resilient in the face of economic downturns, and the benefits of this resilience extend into the community in which an S ESOP operates. Swagel and Carroll (2010) assess how S ESOPs weathered the last recession and confirm that S ESOPs in 2008 fared better than others: “S-ESOP firms were resilient employers in 2008, with employment growing by 1.9 percent among surveyed S-ESOP firms even as it fell by nearly 3 percent in the overall U.S. private sector.”

To estimate the macroeconomic “footprint” of S ESOPs on the US economy, Brill (2013) employs the IMPLAN input-output model to quantify the impact of these firms. Relying on Form 5500 data from 2010, Brill (2013) finds that 2,643 S ESOPs directly employed 470,000 active participants (a conservative proxy for employment, as discussed above) and supported an additional 940,000 jobs. Moreover, total output was equivalent to 1.7 percent of 2010 US GDP. Of this, \$93 billion (or 0.6 percent of GDP) came directly from S ESOPs, while output in supported industries totaled \$153 billion (or 1.1 percent of GDP). Given that S ESOP growth since 2010 has outpaced growth in the overall economy, the role of S ESOPs in the US economy is likely greater now than it was then.

The measurable footprint combined with the demonstrated economic resilience of S ESOPs suggest that these firms yield a tangible stabilizing benefit to the communities in which they operate. During a recession, bankruptcy for small businesses is not uncommon and can have a domino effect, imposing

financial hardship on firm suppliers and other local businesses and impeding local housing markets. To the extent that S ESOPs mitigate these effects, they represent a positive economic externality.

**S ESOPs in the Broader Context: Why This All Matters**

In competing with large corporations who benefit from economies of scale and cost-effective access to capital markets, SMEs are often reliant on business agility, local knowledge, and high-quality workers to remain competitive. By strengthening the ties between workers and managers, the S ESOP structure, like ESOPs generally and other forms of employee stock ownership, can help foster efficiency and increased productivity and output.

The positive effects of S ESOPs should be considered a complement to the benefits of technology gains as a means for overall productivity growth in the US. Given the slow creep of productivity in recent years, S ESOPs are a valuable tool in promoting economic growth not only among small businesses but indirectly to the economy overall.

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**Testimony of**

**STEPHANIE SILVERMAN**

**PRESIDENT and EXECUTIVE DIRECTOR**

**EMPLOYEE-OWNED S CORPORATIONS OF AMERICA**

**Before the**

**HOUSE COMMITTEE ON SMALL BUSINESS**

**HEARING ON**

**"S IS FOR SAVINGS:  
PRO-GROWTH BENEFITS OF EMPLOYEE-OWNED S CORPORATIONS"**

**APRIL 27, 2016**

Good morning Chairman Chabot, Ranking Member Velazquez, and distinguished members of the Committee. My name is Stephanie Silverman and I am the President and Executive Director of the Employee-owned S Corporations of America (ESCA). Thank you for the opportunity to testify today about the success of S corporations that are owned by their employees—so-called “S corporation ESOPs”—and on bipartisan legislation that would expand employee ownership and in doing so generate significant new economic benefits to workers, companies and communities around the country.

ESCA represents S corporation ESP companies operating in every state, in industries ranging from heavy manufacturing to constructions to grocery stores to school photography. There are almost 3,000 ESOPs in the U.S. accounting for \$92 billion in direct economic output. The top four industries by employment are manufacturing (94,000), professional services (80,000), retail trade (73,000) and construction (48,000).

It was twenty years ago that, thanks to the efforts that began with discussions in this committee, Congress ultimately passed legislation creating S corporation ESOPs. Congress’ goal in 1996 was to encourage employee ownership of private industry, enable workers to benefit from their labor, and create a path for building meaningful retirement savings. Data shows that today, S ESOPs are doing exactly that. I’m here to report that Congress did something very right. Twenty years later, private employee-owned companies have been a remarkable success story, a bright spot in an economy characterized by sluggish growth, anemic job creation, and worker insecurity.

Many studies, including those by renowned economists from across the ideological spectrum, tell the story about how S ESOPs are powerful for workers as a retirement savings and economic security tool, and how they have contributed substantially to communities and the broader national economy. I will just touch on a few key points from the most recent studies:

- Earlier this year, economist Jared Bernstein, formerly Vice President Biden’s chief economist, released a study that shows that ESOPs reduce wage and wealth inequality. Moreover, Bernstein found, ESOP companies pay their workers better wages and provide them with more stable employment than other businesses. With Congress searching for solutions to improve savings rates as well as job prospects and wages for American workers, ESOPs tell us that we can achieve this goal by increasing capital ownership among our workers.
- At a time when almost half of working Americans do not have *any* retirement plan at work, ESOPs also provide unparalleled retirement savings opportunities for many workers. Employee-owners are able to amass more retirement savings if they are in an ESOP. Indeed, EY’s Quantitative Economics and Statistics practice found that, from 2002-2012, S ESOPs outperformed the S&P 500 in terms of total return by participant by 62%, net assets increased over 300%, and distributions to participants totaled nearly \$30 billion.

- The additional savings benefit to employees also does not come with additional risk to them: S ESOP companies are a safe investment for their employee owners as private, employee-owned businesses are proven to be more stable than their counterparts. In June 2014, the National Center for Employee Ownership released data showing that the default rate on bank loans to ESOP companies during the period 2009-2013 was, on average, an unusually low 0.2 percent annually. This compares to mid-market companies defaulting on loans at an annual rate of 2 to 3.75 percent.
- Finally, it's worth noting that in ESCA, nearly 80 percent of our companies offer not just ESOP-based savings, but at least one other defined benefit or defined contribution plan.

About eight years ago, as Members of Congress began to hear from companies and workers in their districts the tremendous benefits of employee-owned companies, they began asking, "What can Congress do to encourage more ESOPs, and with them more savings, job security and wage equality?"

The answer to that question prompted what is currently H.R. 2096, the Promotion and Expansion of Private Employee Ownership Act. First introduced by Congressman Ron Kind in the 111th Congress, the bill has been introduced in the next three Congresses, and led by Congressman Dave Reichert and Kind. Last April, Congressman Reichert and Kind were joined by six additional members of the House Ways and Means Committee as original cosponsors of HR 2096—Reps. Tiberi, Neal, Boustany, Blumenauer, Paulsen and Pascrell. Today, that measure has 67 co-sponsors, including 21 members of the Ways and Means Committee. In the Senate, the counterpart measure—S. 1212—has 28 cosponsors, including 8 members of the tax-writing Senate Finance Committee.

In short, it would:

- Provide incentives to owners of existing S corporations to sell their stock to an ESOP. Today, such incentives exist only for owners of C corporations: Section 1042 of the Tax Code allows a C corporation owner to defer the recognition of gains when the owner sells shares to an ESOP when the proceeds are reinvested into other securities. Extending parity to S corporation owners is the most significant legislative action that Congress could take to encourage more of the millions of S corporation owners to choose an ESOP when they consider how to transition their business from their current ownership.
- Encourage banks to lend to S ESOPs for the purpose of creating more ESOP ownership of a company. Under this proposal, banks could deduct 50% of interest income received on certain loans made to an ESOP. This incentive is vital because employees often lack the funds to buy the company directly, and not all banks understand the ESOP structure, which may cause them to limit their lending to these vibrant businesses.
- Provide assistance to would-be S ESOP companies by providing for an S Corporation Employee Ownership Assistance office at the Department of Treasury that can aide business

owners who may be interested in forming an S corporation ESOP and, finally,

- Permit an SBA-certified small business to remain eligible for SBA programs after becoming majority-owned by an ESOP as long as employee demographics remain the same.

Quite simply, more S ESOPs means more worker savings, wealth and wage equality, job stability and national economic benefit. That is why we hope this Committee and your colleagues in Congress will help advance this vital measure.

### **CONCLUSION**

Mr. Chairman and committee members, on behalf of ESCA and the thousands of employee-owners from our member companies, as well as the almost half a million Americans who work for S corporation ESOP companies today, we thank you for holding this hearing to highlight the savings and other economic benefits of S corporation ESOPs and employee ownership. We look forward to working with all of you to grow support for and move H.R. 2096. I would be happy to answer any questions.

